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SUBJECT: PAULSON DISCUSSES FINANCIAL MARKETS, IRAN WITH SARKOZY, LAGARDE

Classified by EMIN Seth Winnick for reasons 1.4 (b) and (d)

¶1. (C) Summary: In successive meetings Treasury Secretary Hank Paulson told Minister of Finance Christine Lagarde and President Nicolas Sarkozy that it was important not to overreact to financial market turbulence. Sarkozy asked for U.S. support for Dominique Strauss-Kahn's candidacy for IMF Managing Director. Discussions also touched on continued cooperation on Iran, Sarkozy's reform agenda and China. End summary.

¶2. (C) During a September 17 visit to France, Treasury Secretary Paulson and accompanying delegation met with Sarkozy and Lagarde, and lunched with leading representatives of France's business community. Sarkozy made a strong push for public U.S. support for Dominique Strauss-Kahn's candidacy for Managing Director of the IMF. Calling Strauss-Kahn the "smartest socialist," Sarkozy said it was important not to encourage President Putin by entertaining the candidacy Czech Josef Tosovksy, who has KGB ties.

¶3. (C) In response to Secretary Paulson's urging that France's business and financial sectors reduce exposure to Iran, Sarkozy said the United States could count on French cooperation in toughening sanctions. "There will be no double talk from France. Stopping the bomb is more important than business contracts." But Sarkozy said unilateral legislation under consideration in the U.S. Congress would be a "disaster" and make the Iranians "very happy." Sarkozy's diplomatic advisor Jean-David Levitte noted that France would look to work, if necessary, outside the Security Council, notably with EU partners, on further measures against Iran.

¶4. (C) On sub-prime-related market turbulence, Sarkozy said regulation was needed to forestall such events and minimize impact on global economic growth. Paulson underscored the importance of not over-reacting. It would take months, not weeks, for credit to be re-priced, but this was "not a major crisis." Several issues were coming into focus: conduits and other off-balance sheet funding vehicles had been a surprise; in the U.S. there was a need to look at mortgage origination, as well as the role of regulatory supervision and rating agencies. Asked for his views on French banks, Paulson said they had strong balance sheets and were profitable, though they, too, might have challenging off-balance sheet obligations. Paulson said the German Landesbanken were "the biggest problem," though they presented little systemic risk and would be bailed out by the German taxpayer.

¶5. (C) Sarkozy asked for views on U.S. exchange rate policy. Paulson said the United States supported a strong dollar. Exchange rates ultimately were market-driven and the U.S. would pursue policies that increased confidence in the U.S. economy. In an exchange on China, Paulson said the U.S. message to China was that if it wanted to be a "member of the club," it needed to adhere to global norms on issues such as Sudan, Iran as well as market-determined exchange rates. The real concern was not that

China's economy would pass that of the United States, but that China would reform too slowly and ultimately run into problems. Paulson asked Sarkozy to "make a big impact" in China by carrying a similar message.

¶6. (C) In a brief exchange on trade issues, Sarkozy said France was not afraid of globalization, but would insist on reciprocity in its foreign relations. Sarkozy was not shocked that the United States defended its farmers: "we're doing the same." Paulson pushed Sarkozy to help "drive Doha to a conclusion." Sarkozy would "do (his) best," but could not support a deal that was not fair to France.

Lagarde on Economic Reform, China and Financial Markets

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¶7. (C) Finance Minister Lagarde sketched out GOF reform priorities, saying the real focus would be on France's social programs and associated costs. Reform of the so-called "special pension regimes" for certain categories of public workers (including rail workers) was high on the agenda. The GOF wanted to bring such pensions in line with those of other public sector employees. Lagarde acknowledged that the issue had brought down the Juppe government in the mid 1990s, but said the GOF would be tough on pension reform. Product market reform - including changes to distribution and retail sectors - was also in the offing.

¶8. (C) Touching on issues subsequently raised by Sarkozy, Lagarde said the GOF wanted strong cooperation on Iran. She suggested an informal U.S. Treasury - Ministry of Finance "task force" be created to look at Iran-related banking issues. Paulson noted that BNP-Paribas had suspended work in Iran, but that Natixis had become more active. Beyond the financial

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sector, it would be important to look at the role of industrial companies in Iran, Paulson said. Although France's exports to Iran were a small percentage of its overall exports, they represented 8% of Iran's imports. French Treasury director Xavier Musca underscored the importance of the U.S. consulting with the GOF before engaging directly with French banks on Iran.

¶9. (C) Lagarde and Musca worried about China's (as well as the UAE's) role as financier for Iran, as well as its undermining of good governance efforts in Africa with easy money. More generally, Lagarde said the weakness of the yuan was "hurting our economies." The 9/14 informal Ecofin meeting in Porto saw agreement to add exchange rate issues to the EU - China summit agenda in November. Lagarde suggested that Brazil and South Africa be brought in on the issue. Paulson said the U.S. was pushing for reform and financial market opening in China, and "this would help all investors." He agreed to raise yuan exchange rate issue with RSA Finance Minister Trevor Manuel in the context of the November G-20 finance ministers meeting.

¶10. (C) On financial market issues, Lagarde said the large French banks were strong, with minimal exposure to asset-backed securities. She was "fairly confident" that the smaller banks were also well-positioned. Market transparency and related issues had been discussed in Porto, and would be the subject of ongoing consultations within the EU. Paulson said the President's Working Group on Financial Markets was looking at similar issues, including conduits and off-balance-sheet items of regulated institutions. But it was important to guard against overreaction. In particular Paulson said he sensed that Europe was "obsessed" with hedge funds. Though the link to regulated institutions (via bank lending) was an important issue, it was hard to blame hedge funds for current market turbulence. Asked about sovereign wealth funds, Lagarde said the issue was not as big a deal in France as it was in Germany.

¶11. (U) The Paulson delegation has cleared this cable.

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